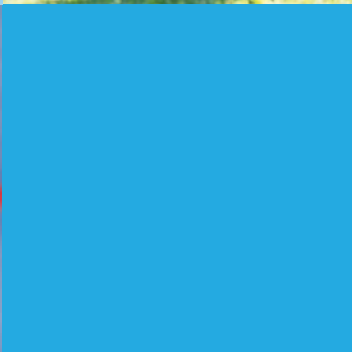


ECONOMICS TODAY

The Macro View



NINETEENTH EDITION

Roger LeRoy Miller



OUR NATIONAL INCOME ACCOUNTS AND REAL GDP SINCE 1929*

In this table, in which all amounts are in billions of dollars, we see historical data for the various components of nominal GDP. These are given in the first four columns. We then show the rest of the national income accounts going from GDP to NDP to NI to PI to DPI. The last column gives real GDP.

Year	The Sum of Expenditures				Equals	Less	Equals	Plus	Less	Equals	Less			Plus	Equals	Less	Equals	Real GDP (2009 Dollars)
	Personal Consumption Expenditures	Gross Private Domestic Investment	Government Purchases of Goods and Services	Net Exports	Gross Domestic Product	Depreciation	Net Domestic Product	Net U.S. Income Earned Abroad	Statistical Discrepancy	National Income	Corporate Profits	Social Security Taxes	Taxes on Production and Imports Net of Subsidies	Net Transfers and Interest Earnings	Personal Income	Personal Income Taxes and Nontax Payment	Disposable Personal Income	
1929	77.3	16.7	8.9	0.3	103.2	9.9	93.3	0.8	9.4	84.7	10.5	0.0	2.6	14.3	85.9	2.6	83.3	***
1933	45.8	1.6	8.3	0.1	55.7	7.6	48.1	0.3	9.0	39.4	-1.2	0.3	6.4	13.1	47.0	1.5	45.5	***
1940	71.0	13.4	1.2	1.4	100.1	9.4	90.7	0.4	11.5	79.6	2.0	2.3	15.0	18.0	78.3	2.6	75.7	***
1944	108.2	7.7	97.1	-2.2	210.9	12.0	198.9	3.5	19.8	182.6	23.8	5.2	18.9	30.6	165.3	19.0	146.3	***
1950	192.1	55.1	38.8	0.7	286.7	23.6	263.1	1.5	24.8	239.8	37.7	6.9	19.7	52.1	227.6	20.7	206.9	***
1955	257.9	69.7	75.3	0.4	403.3	34.3	369.0	2.6	35.3	336.3	46.9	11.1	25.5	58.1	310.9	35.6	275.3	***
1960	331.7	78.9	111.6	4.2	526.4	55.6	470.8	3.1	1.0	474.9	49.9	20.7	66.5	63.2	401.0	51.0	350.0	2758.7
1965	443.8	118.2	151.5	5.6	719.1	70.7	648.4	5.3	-0.3	653.4	76.1	29.6	84.2	75.4	538.9	65.7	473.2	3607.0
1970	647.7	170.1	254.2	3.9	1075.9	136.8	939.1	6.4	-5.4	940.1	86.2	46.4	86.6	143.7	864.6	103.1	761.5	4717.7
1973	851.1	266.9	306.4	4.1	1428.5	178.1	1250.4	12.6	-6.0	1257.0	133.4	75.5	112.0	202.4	1138.5	132.4	1006.1	5418.2
1974	932.0	274.5	343.1	-0.8	1548.8	206.2	1342.6	15.5	-7.3	1350.8	125.7	85.2	121.6	231.0	1249.3	151.0	1098.3	5390.2
1975	1032.8	257.3	382.9	15.9	1688.9	237.5	1451.4	13.0	-13.3	1451.1	138.9	89.3	130.8	274.8	1366.9	147.6	1219.3	5379.5
1976	1150.2	323.2	405.8	-1.6	1877.6	259.2	1618.4	16.9	-20.5	1614.8	174.3	101.3	141.3	300.2	1498.1	172.3	1325.8	5669.3
1977	1276.7	396.6	435.8	-23.1	2086.0	288.3	1797.7	20.3	-19.3	1798.7	205.8	113.1	152.6	327.0	1654.2	197.5	1456.7	5930.6
1978	1426.2	478.4	477.4	-25.4	2356.6	325.1	2031.5	21.6	-23.2	2029.9	238.6	131.3	162.0	361.5	1859.5	229.4	1630.1	6260.4
1979	1589.5	539.7	525.5	-22.6	2632.1	371.1	2261.0	31.9	-44.7	2248.2	249.0	152.7	171.6	403.0	2077.9	268.6	1809.3	6459.2
1980	1754.6	530.1	590.8	-13.0	2862.5	426.0	2436.5	34.2	-43.9	2426.8	223.6	166.2	190.5	470.3	2316.8	298.8	2018.0	6443.4
1981	1937.5	631.2	654.7	-12.5	3210.9	485.0	2725.9	32.9	-36.7	2722.1	247.5	195.7	224.2	541.2	2595.9	345.2	2250.7	6610.6
1982	2073.9	581.0	710.0	-19.9	3345.0	534.3	2810.7	36.5	-6.8	2840.4	229.9	208.9	225.9	603.1	2778.8	354.1	2424.7	6484.3
1983	2286.5	637.5	765.7	-51.6	3638.1	560.5	3077.6	37.1	-54.2	3060.5	279.8	226.0	242.0	657.0	2969.7	352.3	2617.4	6784.7
1984	2498.2	820.1	825.2	-102.8	4040.7	594.3	3446.4	36.3	-38.7	3444.0	337.9	257.5	268.7	701.4	3281.3	377.4	2903.9	7277.2
1985	2722.7	829.6	908.4	-114.0	4346.7	636.7	3710.0	25.4	-51.2	3684.2	354.5	281.4	286.9	754.5	3515.9	417.4	3098.5	7585.7
1986	2898.4	849.1	974.5	-131.9	4590.1	682.2	3907.9	16.9	-76.6	3848.2	324.4	303.4	298.5	803.2	3725.1	437.2	3287.9	7852.1
1987	3092.1	892.2	1030.8	-144.9	4870.2	728.0	4142.2	17.5	-40.5	4119.2	366.0	323.1	317.3	842.5	3955.3	489.0	3466.3	8123.9
1988	3346.9	937.0	1078.2	-109.5	5252.6	782.4	4470.2	22.6	0.6	4493.4	414.9	361.5	345.0	903.3	4275.3	504.9	3770.4	8465.4
1989	3592.8	999.7	1151.9	-86.7	5657.7	836.1	4821.6	24.8	-64.2	4782.2	414.2	385.2	371.4	1006.8	4618.2	566.1	4052.1	8777.0
1990	3825.6	993.5	1238.4	-77.9	5979.6	886.8	5092.8	34.6	-91.3	5036.1	417.2	410.1	398.0	1093.7	4904.5	592.7	4311.8	8945.4

*Note: Some rows may not add up due to rounding.

OUR NATIONAL INCOME ACCOUNTS AND REAL GDP SINCE 1929*

In this table, in which all amounts are in billions of dollars, we see historical data for the various components of nominal GDP. These are given in the first four columns. We then show the rest of the national income accounts going from GDP to NDP to NI to PI to DPI. The last column gives real GDP.

Year	The Sum of Expenditures				Equals	Less	Equals	Plus	Less	Equals	Less		Plus	Equals	Less	Equals	Real GDP (2009 Dollars)	
	Personal Consumption Expenditures	Gross Private Domestic Investment	Government Purchases of Goods and Services	Net Exports	Gross Domestic Product	Depreciation	Net Domestic Product	Net U.S. Income Earned Abroad	Statistical Discrepancy	National Income	Corporate Profits	Social Security Taxes	Taxes on Production and Imports Net of Subsidies	Net Transfers and Interest Earnings	Personal Income	Personal Income Taxes and Nontax Payment		Disposable Personal Income
1991	3960.2	944.3	1298.2	-28.7	6174.0	931.1	5242.9	31.6	-88.4	5186.1	451.3	430.2	429.6	1196.1	5071.1	586.6	4484.5	8938.9
1992	4215.7	1013.0	1345.4	-34.8	6539.3	959.7	5579.6	31.1	-111.0	5499.7	475.3	455.0	453.3	1294.7	5410.8	610.5	4800.3	9256.7
1993	4471.0	1106.8	1366.1	-65.2	6878.7	1003.6	5875.1	32.0	-152.3	5754.8	522.0	477.4	466.4	1357.8	5646.8	646.6	5000.2	9510.8
1994	4741.0	1256.5	1403.7	-92.5	7308.7	1055.6	6253.1	23.8	-136.7	6140.2	621.9	508.2	512.7	1437.3	5934.7	690.5	5244.2	9894.7
1995	4984.2	1317.5	1452.2	-89.9	7664.0	1122.8	6541.2	28.7	-90.4	6479.5	703.0	532.8	523.1	1555.9	6276.5	743.9	5532.6	10163.7
1996	5268.1	1432.1	1496.4	-96.4	8100.2	1176.0	6924.2	31.8	-56.6	6899.4	786.1	555.1	545.5	1649.2	6661.9	832.0	5829.9	10549.5
1997	5560.7	1595.6	1554.2	-102.0	8608.5	1240.0	7368.5	24.1	-12.2	7380.4	865.8	587.2	577.8	1725.4	7075.0	926.1	6148.9	11022.9
1998	5903.0	1735.3	1613.5	-162.7	9089.1	1310.3	7778.8	18.3	60.2	7857.3	804.1	624.7	603.1	1762.3	7587.7	1026.4	6561.3	11513.4
1999	6316.9	1884.2	1726.0	-261.4	9665.7	1400.9	8264.8	27.1	32.5	8324.4	830.2	661.3	628.4	1779.3	7983.8	1107.5	6876.3	12071.4
2000	6792.4	2033.8	1834.4	-375.8	10284.8	1514.2	8770.6	37.0	99.4	8907.0	781.2	705.8	662.7	1875.5	8632.8	1232.3	7400.5	12559.7
2001	7103.1	1928.6	1958.8	-368.7	10621.8	1604.0	9017.8	51.8	114.9	9184.5	754.0	733.2	669.0	1958.8	8987.1	1234.8	7752.3	12682.2
2002	7384.1	1925.0	2094.9	-426.5	10977.5	1662.1	9315.4	48.6	72.8	9436.8	907.2	751.5	721.2	2092.6	9149.5	1050.3	8099.2	12098.8
2003	7764.5	2027.9	2220.8	-502.6	11510.7	1727.2	9783.5	68.0	13.6	9865.1	1056.4	779.3	758.9	2217.1	9487.6	1000.9	8486.7	13271.1
2004	8260.0	2276.7	2357.4	-619.2	12274.9	1831.7	10443.2	90.0	8.7	10541.9	1283.3	829.2	817.6	2437.4	10049.2	1046.0	9003.2	13773.5
2005	8794.1	2527.1	2493.7	-721.2	13093.7	1982.0	11111.7	93.5	35.6	11240.8	1477.7	873.3	873.6	2594.1	10610.3	1208.5	9401.8	14234.2
2006	9304.0	2680.6	2642.2	-770.9	13855.9	2136.0	11719.9	68.5	217.2	12005.6	1646.5	922.6	940.5	2893.8	11389.8	1352.1	10037.7	14613.8
2007	9750.5	2643.7	2801.9	-718.5	14477.6	2264.4	12213.2	126.4	-17.3	12322.3	1529.0	961.4	980.0	3143.8	11995.7	1487.8	10507.9	14873.7
2008	10013.6	2424.8	3003.2	-723.0	14718.6	2363.4	12355.2	173.0	-97.4	12430.8	1285.1	988.2	989.4	3262.5	12430.6	1107.6	10995.4	14830.4
2009	9847.0	1878.1	3089.1	-395.5	14418.7	2368.4	12050.3	147.2	-73.0	12124.5	1392.6	964.4	967.8	3282.4	12082.1	1144.9	10937.2	14418.7
2010	10202.2	2100.8	3174.0	-512.6	14964.4	2381.6	12582.8	205.9	-49.2	12739.5	1740.6	984.1	1001.2	3421.6	12435.2	1191.5	11243.7	14783.8
2011	10689.3	2239.9	3168.7	-580.0	15517.9	2452.6	13065.3	260.7	69.7	13395.7	1877.7	918.2	1037.2	3628.7	13191.3	1403.9	11787.4	15020.6
2012	11050.6	2511.7	3158.6	-565.6	16155.3	2542.9	13612.4	252.9	106.3	13971.6	2009.5	950.7	1065.6	3798.0	13743.8	1498.0	12245.8	15354.6
2013	11392.3	2665.0	3114.2	-508.3	16663.2	2646.6	14016.6	257.8	258.7	14533.1	2102.1	1106.1	1088.0	3898.9	14135.8	1659.1	12476.7	15583.8
2014	11865.9	2860.0	3152.1	-529.9	17348.1	2761.5	14586.6	258.4	136.3	14981.3	2161.0	1162.9	1163.5	4280.9	14774.8	1792.1	12982.7	15961.7
2015	12267.9	3017.8	3184.0	-531.9	17937.8	2832.6	15105.2	259.3	251.1	15615.6	2049.9	1207.9	1179.0	4264.9	15443.7	1957.3	13486.4	16341.8
2016 ^a	12734.8	3211.3	3219.5	-554.3	18611.3	2930.4	15680.9	261.4	244.5	16186.7	2151.3	1238.4	1185.4	4520.3	16131.9	2110.3	14021.6	16734.5
2017 ^a	13213.0	3417.3	3255.4	-566.7	19319.0	3031.7	16287.3	263.7	227.7	16778.7	2169.8	1264.2	1194.7	4590.8	16740.8	2163.0	14577.8	17136.7

a = author's estimates

MACROECONOMIC PRINCIPLES

Nominal versus Real Interest Rate

$$i_n = i_r + \text{expected rate of inflation}$$

where i_n = nominal rate of interest
 i_r = real rate of interest

Marginal versus Average Tax Rates

$$\text{Marginal tax rate} = \frac{\text{change in taxes due}}{\text{change in taxable income}}$$
$$\text{Average tax rate} = \frac{\text{total taxes due}}{\text{total taxable income}}$$

GDP—The Expenditure and Income Approaches

$$\text{GDP} = C + I + G + X$$

where C = consumption expenditures
 I = investment expenditures
 G = government expenditures
 X = net exports

$$\text{GDP} = \text{wages} + \text{rent} + \text{interest} + \text{profits}$$

Say's Law

Supply creates its own demand, or *desired* aggregate expenditures will equal *actual* aggregate expenditures.

Saving, Consumption, and Investment

$$\text{Consumption} + \text{saving} = \text{disposable income}$$
$$\text{Saving} = \text{disposable income} - \text{consumption}$$

Average and Marginal Propensities

$$\text{APC} = \frac{\text{real consumption}}{\text{real disposable income}}$$
$$\text{APS} = \frac{\text{real saving}}{\text{real disposable income}}$$
$$\text{MPC} = \frac{\text{change in real consumption}}{\text{change in real disposable income}}$$
$$\text{MPS} = \frac{\text{change in real saving}}{\text{change in real disposable income}}$$

The Multiplier Formula

$$\text{Multiplier} = \frac{1}{\text{MPS}} = \frac{1}{1 - \text{MPC}}$$
$$\text{Multiplier} \times \begin{matrix} \text{change in} \\ \text{autonomous} \\ \text{real spending} \end{matrix} = \begin{matrix} \text{change in} \\ \text{equilibrium} \\ \text{real GDP} \end{matrix}$$

Relationship between Bond Prices and Interest Rates

The market price of existing (old) bonds is inversely related to “the” rate of interest prevailing in the economy.

Government Spending and Taxation Multipliers

$$M_g = \frac{1}{\text{MPS}}$$
$$M_t = -\text{MPC} \times \frac{1}{\text{MPS}}$$

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Year	The Sum of Expenditures				Equals	Less	Equals	Plus	Less	Equals	Less		Plus	Equals	Less	Equals	Real GDP (2009 Dollars)	
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1991	3960.2	944.3	1298.2	-28.7	6174.0	931.1	5242.9	31.6	-88.4	5186.1	451.3	430.2	429.6	1196.1	5071.1	586.6	4484.5	8938.9
1992	4215.7	1013.0	1345.4	-34.8	6539.3	959.7	5579.6	31.1	-111.0	5499.7	475.3	455.0	453.3	1294.7	5410.8	610.5	4800.3	9256.7
1993	4471.0	1106.8	1366.1	-65.2	6878.7	1003.6	5875.1	32.0	-152.3	5754.8	522.0	477.4	466.4	1357.8	5646.8	646.6	5000.2	9510.8
1994	4741.0	1256.5	1403.7	-92.5	7308.7	1055.6	6253.1	23.8	-136.7	6140.2	621.9	508.2	512.7	1437.3	5934.7	690.5	5244.2	9894.7
1995	4984.2	1317.5	1452.2	-89.9	7664.0	1122.8	6541.2	28.7	-90.4	6479.5	703.0	532.8	523.1	1555.9	6276.5	743.9	5532.6	10163.7
1996	5268.1	1432.1	1496.4	-96.4	8100.2	1176.0	6924.2	31.8	-56.6	6899.4	786.1	555.1	545.5	1649.2	6661.9	832.0	5829.9	10549.5
1997	5560.7	1595.6	1554.2	-102.0	8608.5	1240.0	7368.5	24.1	-12.2	7380.4	865.8	587.2	577.8	1725.4	7075.0	926.1	6148.9	11022.9
1998	5903.0	1735.3	1613.5	-162.7	9089.1	1310.3	7778.8	18.3	60.2	7857.3	804.1	624.7	603.1	1762.3	7587.7	1026.4	6561.3	11513.4
1999	6316.9	1884.2	1726.0	-261.4	9665.7	1400.9	8264.8	27.1	32.5	8324.4	830.2	661.3	628.4	1779.3	7983.8	1107.5	6876.3	12071.4
2000	6792.4	2033.8	1834.4	-375.8	10284.8	1514.2	8770.6	37.0	99.4	8907.0	781.2	705.8	662.7	1875.5	8632.8	1232.3	7400.5	12559.7
2001	7103.1	1928.6	1958.8	-368.7	10621.8	1604.0	9017.8	51.8	114.9	9184.5	754.0	733.2	669.0	1958.8	8987.1	1234.8	7752.3	12682.2
2002	7384.1	1925.0	2094.9	-426.5	10977.5	1662.1	9315.4	48.6	72.8	9436.8	907.2	751.5	721.2	2092.6	9149.5	1050.3	8099.2	12098.8
2003	7764.5	2027.9	2220.8	-502.6	11510.7	1727.2	9783.5	68.0	13.6	9865.1	1056.4	779.3	758.9	2217.1	9487.6	1000.9	8486.7	13271.1
2004	8260.0	2276.7	2357.4	-619.2	12274.9	1831.7	10443.2	90.0	8.7	10541.9	1283.3	829.2	817.6	2437.4	10049.2	1046.0	9003.2	13773.5
2005	8794.1	2527.1	2493.7	-721.2	13093.7	1982.0	11111.7	93.5	35.6	11240.8	1477.7	873.3	873.6	2594.1	10610.3	1208.5	9401.8	14234.2
2006	9304.0	2680.6	2642.2	-770.9	13855.9	2136.0	11719.9	68.5	217.2	12005.6	1646.5	922.6	940.5	2893.8	11389.8	1352.1	10037.7	14613.8
2007	9750.5	2643.7	2801.9	-718.5	14477.6	2264.4	12213.2	126.4	-17.3	12322.3	1529.0	961.4	980.0	3143.8	11995.7	1487.8	10507.9	14873.7
2008	10013.6	2424.8	3003.2	-723.0	14718.6	2363.4	12355.2	173.0	-97.4	12430.8	1285.1	988.2	989.4	3262.5	12430.6	1107.6	10995.4	14830.4
2009	9847.0	1878.1	3089.1	-395.5	14418.7	2368.4	12050.3	147.2	-73.0	12124.5	1392.6	964.4	967.8	3282.4	12082.1	1144.9	10937.2	14418.7
2010	10202.2	2100.8	3174.0	-512.6	14964.4	2381.6	12582.8	205.9	-49.2	12739.5	1740.6	984.1	1001.2	3421.6	12435.2	1191.5	11243.7	14783.8
2011	10689.3	2239.9	3168.7	-580.0	15517.9	2452.6	13065.3	260.7	69.7	13395.7	1877.7	918.2	1037.2	3628.7	13191.3	1403.9	11787.4	15020.6
2012	11050.6	2511.7	3158.6	-565.6	16155.3	2542.9	13612.4	252.9	106.3	13971.6	2009.5	950.7	1065.6	3798.0	13743.8	1498.0	12245.8	15354.6
2013	11392.3	2665.0	3114.2	-508.3	16663.2	2646.6	14016.6	257.8	258.7	14533.1	2102.1	1106.1	1088.0	3898.9	14135.8	1659.1	12476.7	15583.8
2014	11865.9	2860.0	3152.1	-529.9	17348.1	2761.5	14586.6	258.4	136.3	14981.3	2161.0	1162.9	1163.5	4280.9	14774.8	1792.1	12982.7	15961.7
2015	12267.9	3017.8	3184.0	-531.9	17937.8	2832.6	15105.2	259.3	251.1	15615.6	2049.9	1207.9	1179.0	4264.9	15443.7	1957.3	13486.4	16341.8
2016 ^a	12734.8	3211.3	3219.5	-554.3	18611.3	2930.4	15680.9	261.4	244.5	16186.7	2151.3	1238.4	1185.4	4520.3	16131.9	2110.3	14021.6	16734.5
2017 ^a	13213.0	3417.3	3255.4	-566.7	19319.0	3031.7	16287.3	263.7	227.7	16778.7	2169.8	1264.2	1194.7	4590.8	16740.8	2163.0	14577.8	17136.7

a = author's estimates

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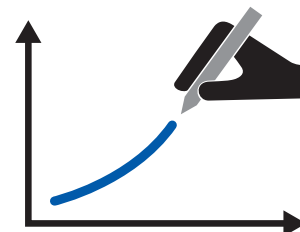
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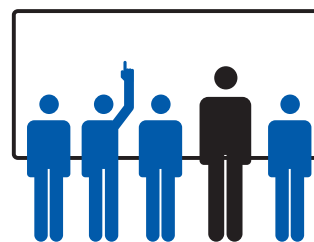
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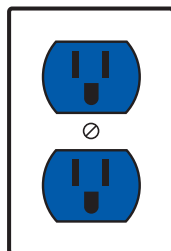
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Roger LeRoy Miller

*Research Professor of Economics,
University of Texas-Arlington*



New York, NY

Dedication

To Albert Starr,
Your vigor, stamina, and intellectual
curiosity continue to amaze me
(and everyone else, too).
It's an honor to know you.

—R.L.M.

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BRIEF CONTENTS

Preface xvi

- PART 1 Introduction**
- 1 The Nature of Economics 1
 - 2 Scarcity and the World of Trade-Offs 27
 - 3 Demand and Supply 49
 - 4 Extensions of Demand and Supply Analysis 75
 - 5 Public Spending and Public Choice 100
 - 6 Funding the Public Sector 124
- PART 2 Introduction to Macroeconomics and Economic Growth**
- 7 The Macroeconomy: Unemployment, Inflation, and Deflation 142
 - 8 Measuring the Economy's Performance 164
 - 9 Global Economic Growth and Development 189
- PART 3 Real GDP Determination and Fiscal Policy**
- 10 Real GDP and the Price Level in the Long Run 212
 - 11 Classical and Keynesian Macro Analyses 232
 - 12 Consumption, Real GDP, and the Multiplier 253
 - 13 Fiscal Policy 281
 - 14 Deficit Spending and the Public Debt 303
- PART 4 Money, Stabilization, and Growth**
- 15 Money, Banking, and Central Banking 322
 - 16 Domestic and International Dimensions of Monetary Policy 349
 - 17 Stabilization in an Integrated World Economy 374
 - 18 Policies and Prospects for Global Economic Growth 397
- PART 8 Global Economics**
- 32 Comparative Advantage and the Open Economy 710
 - 33 Exchange Rates and the Balance of Payments 732

CONTENTS

Preface xvi

PART 1 Introduction

EXAMPLE

Microeconomic and Macroeconomic Implications of the *Gig Economy* 3
Getting Directions 8

INTERNATIONAL POLICY EXAMPLE

Greece Discovers That Higher Tax Rates Encourage More Tax Evasion 6

BEHAVIORAL EXAMPLE

Why Doesn't Higher Pay Persuade Some Women to Avoid Traditional Gender Roles? 7

EXAMPLE

The Airline Industry Confronts the Law of Increasing Additional Cost 36

POLICY EXAMPLE

Why the "Free File" Tax Service Is Not Really "Free" 30

INTERNATIONAL EXAMPLE

The Substantial Trade-Off of Satisfying U.N. Development Goals 34

BEHAVIORAL EXAMPLE

An Economic Explanation for Monogamy 32

EXAMPLE

The Law of Demand in the Market for Cable TV Subscriptions 51

Altered Tastes and Preferences Generate Lower Demand for Chewing Gum 57

Long Lines at Restaurants Specializing in Barbecued Brisket Signal a Shortage 67

POLICY EXAMPLE

Policies Generate Higher Water Input Costs and Cut Agricultural Commodity Supplies 64

Should Shortages in the Ticket Market Be Solved by Scalpers? 68

1 The Nature of Economics 1

The Power of Economic Analysis 2 • The Three Basic Economic Questions and Two Opposing Sets of Answers 4

WHAT IF... the government increases pharmaceutical companies' costs but prevents them from raising their prices? 5

The Economic Approach: Systematic Decisions 6 • Economics as a Science 7
• Positive versus Normative Economics 10

YOU ARE THERE The Incentive to Understand Chickens' "Speech" 11

ISSUES & APPLICATIONS Why More Highly Educated Women Are Having More Children 12

Summary: What You Should Know/Where to Go to Practice 13 • Problems 14
• References 17

APPENDIX A Reading and Working with Graphs 18

Direct and Inverse Relationships 18 • Constructing a Graph 19 • Graphing Numbers in a Table 20 • The Slope of a Line (A Linear Curve) 22 • **Summary:** What You Should Know/Where to Go to Practice 25 • Problems 26

2 Scarcity and the World of Trade-Offs 27

Scarcity 28 • Opportunity Cost, Trade-Offs, and Choices 30 • The Economic Choices a Nation's People Face 33 • Economic Growth, Production Possibilities, and the Trade-Off between Present and Future 37

WHAT IF... the U.S. government continues to ratchet up required production of health care services? 39

Specialization, Comparative Advantage, and Trade 39

YOU ARE THERE Reducing the Opportunity Cost of Waiting in Gridlocked Traffic, at a Price 42

ISSUES & APPLICATIONS The U.S. Navy Expands Production Possibilities via a New Technology 42

Summary: What You Should Know/Where to Go to Practice 44 • Problems 45
• References 48

3 Demand and Supply 49

Demand 50 • Shifts in Demand 55 • Supply 59 • Shifts in Supply 62 • Putting Demand and Supply Together 65

WHAT IF... the government requires buyers to pay a price that is above the equilibrium price? 68

YOU ARE THERE The Breakfast Cereal Industry Confronts Changing Tastes and Preferences 69

ISSUES & APPLICATIONS The U.S. Oil Gusher Produces Shortages of Oil Storage Space 70

INTERNATIONAL EXAMPLE

A Global Substitution from Coal to Natural Gas as an Energy Source 57
An Increase in the Supply of Automobiles in China 64

BEHAVIORAL EXAMPLE

Tips and Quality-Adjusted Prices 52

EXAMPLE

Dramatic Responses to Cities' Minimum Wage Hikes: "Zeroing Out" Employment 88

POLICY EXAMPLE

Rationing Water 81
Regulating the Raisin Reserve 93

INTERNATIONAL EXAMPLE

Why Are Global Ship Rental Prices Dropping? 80

INTERNATIONAL POLICY EXAMPLE

Looking for Hard-to-Find Items in Venezuela? Ask for the *Bachaqueros* 83
The European Union Decides That the Costs of Milk Quotas Outweigh the Benefits 89

BEHAVIORAL EXAMPLE

Online Dating Sites and Virtual Roses 77

EXAMPLE

Medicare's "1 Percent" 112

POLICY EXAMPLE

That Noisy Drone Hovering by Your House? Your Property Rights Are Unclear 102
Mixed Public Choice Incentives and Policies for School Lunches 115

INTERNATIONAL POLICY EXAMPLE

Is Regulation the Solution for an Expanding Cloud of Orbital Pollution? 104

BEHAVIORAL EXAMPLE

Funding Public Goods: Differences in Valuations versus Competencies 108

EXAMPLE

The Progressive U.S. Income Tax System 126

POLICY EXAMPLE

Inducing Disability Insurance Recipients Not to Work Causes Payouts to Exceed Taxes 130
Are Vehicle User Fees an Inevitable Replacement for Gasoline Excise Taxes? 131

North Carolina Cuts Tax Rates and Expands a Tax Base, and Its Revenue Increase 133

Summary: What You Should Know/Where to Go to Practice 71 • Problems 72
• References 74

4 Extensions of Demand and Supply Analysis 75

The Price System and Markets 76 • Changes in Demand and Supply 77 • The Rationing Function of Prices 80 • Price Ceilings 82

WHAT IF... the government requires apartment owners to set rents based on tenants' incomes? 85

Price Floors and Quantity Restrictions 85

YOU ARE THERE Price Rationing via Changes in the Number of Items Sold in a Package 90

ISSUES & APPLICATIONS Online Middlemen: Customer Sales Reps Move to the Web 90

Summary: What You Should Know/Where to Go to Practice 91 • Problems 92
• References 95

APPENDIX B Consumer Surplus, Producer Surplus, and Gains from Trade within a Price System 96

Consumer Surplus 96 • Producer Surplus 97 • Gains from Trade within a Price System 98 • Price Controls and Gains from Trade 99

5 Public Spending and Public Choice 100

Market Failures and Externalities 101

WHAT IF... the government engages in policies that force down the price of an item subject to external benefits while leaving its supply curve's position unchanged? 105

The Other Economic Functions of Government 105 • The Political Functions of Government 108 • Public Spending and Transfer Programs 109 • Collective Decision Making: The Theory of Public Choice 114

YOU ARE THERE Addressing Rail-Freight Transportation Externalities 116

ISSUES & APPLICATIONS The U.S. Measles Threat—Once Nearly Eliminated but Less So Today 117

Summary: What You Should Know/Where to Go to Practice 118 • Problems 119
• References 122

6 Funding the Public Sector 124

Paying for the Public Sector: Systems of Taxation 125

WHAT IF... borrowing to fund public expenditures was illegal? 125

The Most Important Federal Taxes 127 • Tax Rates and Tax Revenues 131
• Taxation from the Point of View of Producers and Consumers 134

YOU ARE THERE Mergers Move U.S. Firms Abroad and Reduce the U.S. Income Tax Base 136

ISSUES & APPLICATIONS Will Taxing "Remote Sales" Be a Salvation for Sinking State Budgets? 137

BEHAVIORAL EXAMPLE

Trying to Boost Government Tax Receipts by Making Tax Delinquents Feel Bad 134

Summary: What You Should Know/Where to Go to Practice 138 • Problems 139
• References 141

PART 2 Introduction to Macroeconomics and Economic Growth

EXAMPLE

An Increase in the Duration of Unemployment 146

Why a Drop in “Routine Jobs” Is Elevating the Natural Rate of Unemployment 148

POLICY EXAMPLE

How High One’s Price-Level-Adjusted Income Is Depends on Where One Lives 151

INTERNATIONAL EXAMPLE

How Variations in Prices of Imported Items Can Push Apart the PPI and CPI 152

BEHAVIORAL EXAMPLE

Animal Spirits and Business Fluctuations: Can Fear Cause Recessions? 157

EXAMPLE

Correcting GDP for Price Index Changes, 2007–2017 178

POLICY EXAMPLE

Accuracy versus Precision in Measuring Business Fixed Investment 172

INTERNATIONAL EXAMPLE

Complications in Assessing the GDP Effects of the “Free Web” 169
Purchasing Power Parity Comparisons of World Incomes 181

BEHAVIORAL EXAMPLE

Should an Economic “Dashboard” Supplement or Replace GDP? 170

POLICY EXAMPLE

An Annual Quota on Importing Human Capital Fills Up in a Hurry 198

INTERNATIONAL EXAMPLE

Growth Rates around the World 191
A Youth Shrinkage and Aging Capital Contribute to Secular Stagnation in Japan 205

BEHAVIORAL EXAMPLE

Interpersonal Trust and Economic Growth 197

7 The Macroeconomy: Unemployment, Inflation, and Deflation 142

Unemployment 143 • The Major Types of Unemployment 147

WHAT IF... the government requires businesses to provide their employees with a wider range of benefits, such as broader health insurance and longer parental leaves? 147

Inflation and Deflation 149 • Anticipated Versus Unanticipated Inflation 153

• Changing Inflation and Unemployment: Business Fluctuations 155

YOU ARE THERE Is the Level of Prices Rising in Russia? Take a Look at the “Borscht Index” 157

ISSUES & APPLICATIONS Interpreting Employment Data as the *Gig Economy* Grows 158

Summary: What You Should Know/Where to Go to Practice 159 • Problems 161

• References 163

8 Measuring the Economy’s Performance 164

The Simple Circular Flow 165 • National Income Accounting 167 • Two Main Methods of Measuring GDP 171

WHAT IF... a nation’s measure of aggregate economic activity were based on production using inputs that its residents own and operate in other countries? 173

• Other Components of National Income Accounting 176 • Distinguishing Between Nominal and Real Values 178

YOU ARE THERE Redesigning GDP to Take into Account the Treatment of Natural Resources? 181

ISSUES & APPLICATIONS How Big Is the Underground Economy? 182

Summary: What You Should Know/Where to Go to Practice 183 • Problems 185

• References 188

9 Global Economic Growth and Development 189

How Do We Define Economic Growth? 190

WHAT IF... from the perspective of the rule of 70, China and India were able to maintain their high rates of per capita real GDP growth over the next couple of decades? 194

Productivity Growth, Saving, and New Technologies: Fundamental Determinants of Economic Growth 194 • Immigration, Property Rights, and Growth 199

• Economic Development 199 • Are Developed Nations Stuck with Stagnant Growth Prospects? 203

YOU ARE THERE Does More Income Inequality Necessarily Harm Economic Growth? 206

ISSUES & APPLICATIONS Both Quality and Quantity of Regulations Matter for Economic Growth 207

Summary: What You Should Know/Where to Go to Practice 208 • Problems 209

• References 211

PART 3 Real GDP Determination and Fiscal Policy**INTERNATIONAL EXAMPLE**

China's Long String of Rightward Shifts in the *LRAS* Curve 215

Inferring That South African Aggregate Demand Growth Dropped after 2008 224

BEHAVIORAL EXAMPLE

Does The "Sentiment" of Consumers Generate Aggregate Demand Shifts? 219

EXAMPLE

Why U.S. Nominal Wages Have Been Slow to Adjust 239

BEHAVIORAL EXAMPLE

Variations in Credit-Market Sentiment and Aggregate Demand Stocks 243

EXAMPLE

Why the U.S. Economy's Saving Rate Rises During Recessions 260

INTERNATIONAL EXAMPLE

Diminished Rightward Shifts in Germany's Investment Function 264

BEHAVIORAL EXAMPLE

Habit Formation in Consumption Spending and the Multiplier Effect 270

INTERNATIONAL POLICY EXAMPLE

Higher Government Research and Development Generates Offsetting Spending Cuts 288

BEHAVIORAL EXAMPLE

Bounded Rationality and Variations in the Effects of Fiscal Policy on Real GDP 291

10 Real GDP and the Price Level in the Long Run 212

Output Growth and the Long-Run Aggregate Supply Curve 213 • Total Expenditures and Aggregate Demand 215 • Long-Run Equilibrium and the Price Level 220

WHAT IF... there are steady and sustained decreases in the prices of key inputs in the production of energy? 222

Causes of Inflation 222

YOU ARE THERE Watching a Crumbling U.S. River System Impede Growth of Aggregate Supply 225

ISSUES & APPLICATIONS The Implications of U.S. Secular Stagnation for Real GDP and the Price Level 225

Summary: What You Should Know/Where to Go to Practice 227 • Problems 228 • References 231

11 Classical and Keynesian Macro Analyses 232

The Classical Model 233 • Keynesian Economics and the Keynesian Short-Run Aggregate Supply Curve 238 • Shifts in the Aggregate Supply Curve 241 • Consequences of Changes in Aggregate Demand 243 • Explaining Short-Run Variations in Inflation 245

WHAT IF... a nation's economy were to experience demand-pull and cost-push inflation simultaneously? 246

YOU ARE THERE A Japanese Economist Tells His Government, "I Told You So!" 247

ISSUES & APPLICATIONS A Minimum Wage Boost Causes a Puerto Rican Aggregate Supply Shock 248

Summary: What You Should Know/Where to Go to Practice 249 • Problems 250 • References 252

12 Consumption, Real GDP, and the Multiplier 253

Determinants of Planned Consumption and Planned Saving 254 • Determinants of Investment 260 • Determining Equilibrium Real GDP 262 • Keynesian Equilibrium with Government and the Foreign Sector Added 266

WHAT IF... real incomes earned by residents of other nations were to increase? 268

The Multiplier, Total Expenditures, and Aggregate Demand 268

YOU ARE THERE Inferring Low Real GDP Growth from "Restrained" Consumption Spending 273

ISSUES & APPLICATIONS An Investment Spending Slowdown Holds Down U.S. Real GDP 274

Summary: What You Should Know/Where to Go to Practice 275 • Problems 277 • References 279

APPENDIX C The Keynesian Model and the Multiplier 280**13 Fiscal Policy 281**

Discretionary Fiscal Policy 282 • Possible Offsets to Fiscal Policy 284

WHAT IF... a nation's government were to find itself to the right of the top of the Laffer curve? 289

Discretionary Fiscal Policy in Practice: Coping with Time Lags 289 • Automatic Stabilizers 291

YOU ARE THERE Why Are Several States Cutting the Duration of Unemployment Compensation? 292

ISSUES & APPLICATIONS Which Governments Conduct Fiscal Stabilization Most Effectively? 293

Summary: What You Should Know/Where to Go to Practice 294 • Problems 296 • References 299

APPENDIX D Fiscal Policy: A Keynesian Perspective 300

Changes in Government Spending 300 • Changes in Taxes 301 • The Balanced-Budget Multiplier 301 • The Fixed Price Level Assumption 302 • Problems 302

POLICY EXAMPLE

Increasing Costs of Student Loan Forgiveness Are Raising Federal Budget Deficits 306

INTERNATIONAL EXAMPLE

What Nations' Residents Have the Largest Holdings of the U.S. Public Debt? 311

BEHAVIORAL EXAMPLE

Will Taxpayers Eventually Force Government Spending Cuts? 307

14 Deficit Spending and the Public Debt 303

Public Deficits and Debts 304 • Evaluating the Rising Public Debt 307
Growing U.S. Government Deficits: Implications for U.S. Economic Performance 311 • How Could the Government Reduce All of Its Red Ink? 313

WHAT IF... the rich were to respond to higher average and marginal income tax rates by engaging in fewer activities subject to taxation? 314

YOU ARE THERE Want a Balanced Budget? Sell Some Government Assets 316

ISSUES & APPLICATIONS Is Fiscal Policy Drowning in Accumulated Budgetary Red Ink? 316

Summary: What You Should Know/Where to Go to Practice 318 • Problems 319
• References 321

PART 4 Money, Stabilization, and Growth

EXAMPLE

Customers Pay Fees to Hold Hundreds of Billions in Deposits at Banks 330

INTERNATIONAL EXAMPLE

Why Bother with a Debit Card When Payments Can Accompany "Tweets"? 332

INTERNATIONAL POLICY EXAMPLE

What Does Zimbabwe Now Use as Money, and Why? 326

BEHAVIORAL EXAMPLE

Is Money Really Just for "Record Keeping"? 324

EXAMPLE

Interest Rate Movements and U.S. Companies' Cash Holdings 352

BEHAVIORAL EXAMPLE

Can Behavioral Economics Explain the Federal Reserve's Bad Forecasts? 359

15 Money, Banking, and Central Banking 322

Functions and Measures of Money 323

WHAT IF... a type of asset that previously had been regularly exchanged in active trading suddenly experiences a long period of hardly any transactions? 325

• Financial Intermediation and Banks 328 • The Federal Reserve System: The U.S. Central Bank 332 • Fractional Reserve Banking, the Federal Reserve, and the Money Supply 335 • Federal Deposit Insurance 339

YOU ARE THERE In Europe, Some Borrowers Receive Bank Interest Payments on Their Loans 342

ISSUES & APPLICATIONS Why U.S. Taxpayers are Last-Resort Funders of Much of the Financial Industry 343

Summary: What You Should Know/Where to Go to Practice 344 • Problems 346
• References 348

16 Domestic and International Dimensions of Monetary Policy 349

The Demand for Money 350 • How the Fed Influences Interest Rates 352 • Effects of an Increase in the Money Supply 354

WHAT IF... Federal Reserve policies generate a higher level of interest rates intended in part to influence bank lending? 356

Monetary Policy and Inflation 357 • Monetary Policy Transmission and Credit Policy at Today's Fed 359

YOU ARE THERE A Member of Congress Seeks a Fed Policy Rule, Irrespective of the Rule's Name 365

ISSUES & APPLICATIONS Do Federal Open Market Committee "Dot Plots" Chart Confusion? 365

Summary: What You Should Know/Where to Go to Practice 366 • Problems 368
• References 370

APPENDIX E Monetary Policy: A Keynesian Perspective 371

Increasing the Money Supply 372 • Decreasing the Money Supply 372 • Arguments against Monetary Policy 372 • Problems 372

POLICY EXAMPLE

Policy Uncertainty and Reduced Total Planned Expenditures 378
 What Policy-Relevant Inflation Rate Should the Public Try to Predict? 388

BEHAVIORAL EXAMPLE

Do Distorted Beliefs Influence Real GDP and the Unemployment Rate? 389

INTERNATIONAL POLICY EXAMPLE

Indian Farmers Confront “Dead Land” Problems 401

INTERNATIONAL EXAMPLE

Myanmar Ends Monopolies’ Control of Financial Information to Spur Foreign Investment 405

BEHAVIORAL EXAMPLE

Nudging the World’s Poor to Make Different Choices 399

17 Stabilization in an Integrated World Economy 374

Active Versus Passive Policymaking and the Natural Rate of Unemployment 375
 The Phillips Curve: A Rationale for Active Policymaking? 379 • Rational Expectations, the Policy Irrelevance Proposition, and Real Business Cycles 382

WHAT IF... the Federal Reserve were to engage in a policy action that the public is unable to anticipate and therefore surprises all firms and households? 383

Modern Approaches to Justifying Active Policymaking 384 • Behavioral Economics and Macroeconomic Policymaking 388

YOU ARE THERE Are National Inflation Rates Mysteriously “Too Low”? 390

ISSUES & APPLICATIONS Does the Usual Phillips Curve Consider the Wrong Unemployment Rate? 391

Summary: What You Should Know/Where to Go to Practice 393 • Problems 394 • References 396

18 Policies and Prospects for Global Economic Growth 397

Labor Resources and Economic Growth 398 • Capital Goods and Economic Growth 400 • A Recent Shift in Global Growth Trends 401 • Private International Financial Flows as a Source of Global Growth 404 • International Institutions and Policies for Global Growth 406

WHAT IF... the World Bank and the IMF were to face competition from new international lending institutions? 408

YOU ARE THERE Will Renewable Energy “Leapfrog” African Nations to Higher Economic Growth? 409

ISSUES & APPLICATIONS China’s One-Child Policy Relaxed—To Promote Economic Growth 409

Summary: What You Should Know/Where to Go to Practice 410 • Problems 412 • References 415

PART 8 Global Economics**POLICY EXAMPLE**

Ending the U.S. Oil Export Ban 722

INTERNATIONAL EXAMPLE

How African Nations Are Developing Comparative Advantages in Agriculture 716

Why European Firms View Chinese Tourists’ *Parallel Imports* as a Threat 719

BEHAVIORAL EXAMPLE

Has Greater Financial Uncertainty Become an Impediment to Trade? 721

EXAMPLE

Harley-Davidson’s Sales of Motorcycles Are Reduced by the Strong Dollar 742

BEHAVIORAL EXAMPLE

Can Behavioral Economics Help Nations Achieve Balanced Trade? 746

32 Comparative Advantage and the Open Economy 710

Why We Trade: Comparative Advantage and Mutual Gains from Exchange 711
 • Arguments Against Free Trade 718 • Ways to Restrict Foreign Trade 721
 • International Trade Organizations 724

WHAT IF... joining a new regional trade bloc shifts existing trade to countries within that bloc and away from countries in another regional trade bloc? 725

YOU ARE THERE Argentina Specializes in Oil Production to Protect Domestic Jobs 726

ISSUES & APPLICATIONS Drought Induces California Farmers to Double Down on a Comparative Advantage 726

Summary: What You Should Know/Where to Go to Practice 728 • Problems 729 • References 731

33 Exchange Rates and the Balance of Payments 732

The Balance of Payments and International Financial Flows 733 • Deriving the Demand for and Supply of Foreign Exchange 738 • Determining Foreign Exchange Rates 742 • Fixed Versus Floating Exchange Rates 745

WHAT IF... a central bank that fixes its nation’s exchange rate runs out of foreign exchange reserves? 748

YOU ARE THERE Nigeria’s Central Bank Forces a Reduction in the Demand for Foreign Exchange 749

ISSUES & APPLICATIONS A Year of an Appreciation, Lower Import Prices, and Higher Quantity of Foreign Exchange Demanded 750

Summary: What You Should Know/Where to Go to Practice 751 • Problems 752 • References 754

Glossary G-1

Index I-1

How do we motivate students in economics? I believe that we should present them with economic explanations for what is happening around them and throughout the world. Theory may be the backbone of our discipline, but its application is the only way we can help our students understand the importance of economics in their daily lives and for their futures.

New and Increased Emphasis on Behavioral Economics

The theory of bounded rationality forms the basis of behavioral economics. This theory is expanded upon in the introductory chapter, and in many other chapters. More importantly, in keeping with the desire to show the applicability of theory, *every single chapter in the 19th edition has a behavioral economics example.*

New Additional End-of-Chapter Problems

In this 19th edition, you will find six to eight new problems at the end of each chapter. Many are based on the interactive graphs within the chapter. They require students to apply their critical thinking skills learned from the chapter.

New Questions in MyEconLab

With the 19th edition, we have added close to 500 new assignable questions in MyEconLab, expanding the database of questions to an average of over 100 questions per chapter.

MyEconLab—Getting Better with Each Edition

- **Figure Animations:** Figure animations provide a step-by-step walk-through of select figures. Seventy percent of all figures are animated. Figure animations have been updated to reflect changes to the 19th edition.
- **Concept Checks:** Each section of each learning objective concludes with an on-line Concept Check that contains one or two multiple-choice, true/false, or fill-in questions. These checks act as “speed bumps” that encourage students to stop and check their understanding of fundamental terms and concepts before moving on to the next section. The goal of this digital resource is to help students assess their progress on a section-by-section basis, so they can be better prepared for homework, quizzes, and exams.
- **Graphs Updated with Real-Time Data from FRED®:** Data graphs in the eText are continually updated with the latest data from FRED®, which is a comprehensive, up-to-date data set from the Federal Reserve Bank of St. Louis. Students can display a pop-up graph that shows new data plotted in the graph. The goal of this digital feature is to provide students with the most current macro data available so that they can observe the changing impacts of these important variables on the economy.

Assessments using current macro data help students understand changes in economic variables and their impact on the economy. Real-time data analysis exercises in MyEconLab also communicate directly with the Federal Reserve Bank of St. Louis’s FRED® site and automatically update as new data are available.

These exercises allow students to practice with data to better understand the current economic environment.

- **Self Checks:** Self Checks appear at the end of every Learning Objective section. Self Check questions allow students to check their understanding of the key concepts they just read before moving on. All questions and answers are available in MyEconLab.
- **Dynamic Study Modules:** Dynamic Study Modules, available within MyEconLab, continuously assess student performance on key topics in real time, and provide additional and personalized practice content. Dynamic Study Modules exist for every chapter and are available on all mobile devices for on-the-go studying.
- **Digital Interactives:** Digital Interactives are dynamic and engaging assessment activities that promote critical thinking and application of key economic principles. Each Digital Interactive has 3–5 progressive levels and requires approximately 20 minutes to explore, apply, compare, and analyze each topic. Many Digital Interactives include real-time data from FRED®, allowing professors and students to display, in graph and table form, up-to-the-minute data on key macro variables. Digital Interactives can be assigned and graded within MyEconLab, or used as a lecture tool to encourage engagement, classroom conversation, and group work.
- **Learning Catalytics®:** Learning Catalytics® generates classroom discussion, guides lectures, and promotes peer-to-peer learning with real-time analytics. Now students can use any device to interact in the classroom, engage with content, and even draw and share graphs.
- **Enhanced eText for MyEconLab:** The Pearson eText for MyEconLab gives students access to their textbook anytime, anywhere. In addition to note-taking, highlighting, and bookmarking, the Pearson eText offers interactive and sharing features.

Continuing Emphasis on Public Policy

Public policy issues concern your students just as they concern everyone else. Much of the theory throughout this text relates to exactly how changing public policies affect all of us.

- In Chapter 2, readers will find out why “free” tax-filing services from the IRS really aren’t free.
- When water becomes scarcer because of droughts, how politicians respond affects everyone, as your students will read in Chapter 4.
- Poorly defined property rights to airspace occupied by drones is an issue addressed in Chapter 5

ISSUES & APPLICATIONS

The U.S. Navy Expands Production Possibilities via a New Technology

CONCEPTS APPLIED

- Production Possibilities
- Production Possibilities Curve
- Technology

U.S. Navy photo by Mass Communication Specialist 2nd Class Kristopher Kirsop/Released



The U.S. Navy faces an on-going task of producing ship-borne weapons that deliver explosive forces to remote targets. At the same time, the Navy is seeking to expand its fleet of ships afloat. Consequently, the Navy faces an economic problem involving production possibilities.

THE CONTINUING QUEST TO KEEP STUDENT INTEREST HIGH

From the very beginning, *Economics Today* was created to maintain high interest by its readers. Many of the pedagogical devices developed in earlier editions have been perfected and the content for this 19th edition is completely new. They include:

- A **chapter-opening vignette** about a serious application of each chapter's theory with a continuing **Issues & Applications feature** at the end of every chapter. All of these are new to this edition.
- **Learning Objectives** accompany each major chapter section to help focus student reading comprehension and allow for self-assessment to ensure that students have grasped key concepts.
- A "grabber" **Did You Know That ...** feature starts off every chapter. All of these are new.

6

Funding the Public Sector



YOU SHOULD BE **A** few years ago, California began taxing remote sales—revenues of firms based outside the state but with a sufficient physical presence within the state to permit taxation of their California sales under federal law. Some forecasts had indicated that the state would bring in about \$450 million in additional sales tax revenues via taxation of remote sales. In fact, the additional revenues generated by extending sales taxes to California-based revenues of out-of-state firms amounted to closer to \$100 million. A number of other states recently have implemented their own remote sales taxes. Many of these states are, like California several years ago, anticipating significant increases in tax collections. In this chapter, you will learn why most economists predict that the states are overestimating gains in revenues from taxation of remote sales.

ISSUES & APPLICATIONS

Will Taxing "Remote Sales" Be a Salvation for Sinking State Budgets?



DID YOU KNOW THAT... the Midwestern U.S. states are endowed with 80 percent of the fresh water available in the United States and with 20 percent of the fresh water in existence on the planet? In recent years, residents of these states have been developing techniques for transferring some of this water to people residing in other U.S. states and even to residents of other nations. By specializing in water-redistribution technologies, these Midwestern residents hope to engage in trade of fresh water for other goods and services with people living in locations hundreds and even thousands of miles away.

For years, states rarely collected from sellers the sales taxes on out-of-state purchases that consumers made by mail or via orders placed online. Although many states technically required consumers to file special forms to pay "use taxes" on such purchases, few consumers followed through, and states determined that the costs of collecting those taxes outweighed the extra revenues. Recently, however, a number of states have changed course and begun trying to collect sales taxes on the "remote sales" that out-of-state firms make to residents of their states.

- A variety of examples are provided:

DOMESTIC TOPICS AND EVENTS are presented through thought-provoking discussions, such as:

- The Law of Demand in the Market for Cable TV Subscriptions
- Analyzing Tweets to Predict Stock Market Swings

EXAMPLE

The Law of Demand in the Market for Cable TV Subscriptions

Between 2000 and 2017, the inflation-adjusted average nationwide price of a cable TV subscription rose from \$30 per month to about \$67 per month. During the same period, the nationwide number of cable TV subscriptions declined from more than 68 million to just over 50 million. Thus, consistent with the law of demand, a significant reduction in the number of cable TV subscriptions has taken place in response to a substantial increase in the inflation-adjusted price of cable TV subscriptions.

FOR CRITICAL THINKING
Is there an inverse relationship between the price of cable TV subscriptions and the number of subscriptions that people purchase? Explain.

Sources are listed at the end of this chapter.

MyEconLab Concept Check

IMPORTANT POLICY QUESTIONS help students understand public debates, such as:

- That Noisy Drone Hovering by Your House? Your Property Rights Are Unclear
- Ending the U.S. Oil Export Ban

POLICY EXAMPLE

Policies Generate Higher Water Input Costs and Cut Agricultural Commodity Supplies

Large quantities of a number of agricultural commodities are grown each year in California. Farmers who reside in this state provide large portions of the nation's almonds, apples, cotton, oranges, grapes, lemons, rice, walnuts, and other commodities.

In recent years, both the U.S. government and the California government have responded to severe droughts by redirecting large volumes of water away from farmers in favor of city water systems and to rivers and streams with endangered fishes. Farmers have had to pay much higher prices to obtain water for their crops from private sources, which has

pushed up considerably the cost of this key input. As a consequence, supplies of agricultural commodities have declined in California.

FOR CRITICAL THINKING
What do you suppose has happened to the positions of the supply curves in the markets for commodities such as almonds, apples, cotton, oranges, grapes, lemons, rice, and walnuts?

Sources are listed at the end of this chapter.

BEHAVIORAL EXAMPLES introduce behavioral economics examples with provocative questions such as:

- Tips and Quality-Adjusted Prices
- Why Doesn't Higher Pay Persuade Some Women to Avoid Traditional Gender Roles?

BEHAVIORAL EXAMPLE

Tips and Quality-Adjusted Prices

Alongside the explicit prices that consumers pay for services such as the provision of food at restaurants, drinks at bars, and taxi services, many consumers of such services commonly extend tips—additional payments—to those who deliver such services. In many instances, therefore, the overall prices that consumers end up paying for these services turn out to be higher than the services' posted prices.

What accounts for the observed behavior of consumers who include tips within overall prices for many services? Some observers have suggested three possible rationales: (1) attempts by consumers to build their own self-esteem by rewarding others, (2) altruistic motives of consumers, or (3) a sense of obligation by consumers. The key economic explanation for tipping, however, starts with the fact that consumers who purchase products such as food at restaurants, mixed drinks, or taxi services know how much they

are willing to pay for services provided in a satisfactory way. Firms that allow employees who provide such services to accept tips typically employ people with hard-to-measure skills in providing the services. By allowing tipping, firms enable consumers to pay a price consistent with the overall quality of the service they actually do receive. That is, tipping behavior ensures a quality-adjusted price that consumers are willing to pay for a delivered service.

FOR CRITICAL THINKING
How could laws that ban tips cause a reduction in the quality of the delivery of services?

Sources are listed at the end of this chapter.

MyEconLab Concept Check

INTERNATIONAL EXAMPLE

How African Nations Are Developing Comparative Advantages in Agriculture

The African continent contains about half of the uncultivated but arable land in the world. It also contains many people who could, in principle, farm much of this land. Nevertheless, for many years, African countries have imported most agricultural products.

During the past decade, a number of African nations have developed comparative advantages in several varieties of corn and coffee. The continent's comparative-advantage turnaround has been assisted by adoption of drought-resistant crop varieties. The key change, however, has been the widespread acquisition of additional physical and human capital. African farmers are using more machinery to plant and harvest their crops. Furthermore, they are acquiring training in how to apply modern farming

techniques. These developments have enabled African farmers to reduce considerably the opportunity cost of agricultural products in terms of other goods and services. As the opportunity costs of African agricultural goods have declined, new comparative advantages in producing these goods and gains from specialization and trade have followed.

FOR CRITICAL THINKING

Why do you think that increased specialization in specific agricultural products has accompanied growth in African exports of those products?

Sources are listed at the end of this chapter.

INTERNATIONAL EXAMPLES AND INTERNATIONAL POLICY EXAMPLES

emphasize the continued importance of international perspectives and policy, such as:

- Looking for Hard-to-Find Items in Venezuela? Ask for the *Bachaqueros*
- How African Nations Are Developing Comparative Advantages in Agriculture

All of these are new to this edition and each has three references from which the information was obtained (these references can be found at the back of each chapter).

WHAT IF? FEATURES

in each chapter aim to help students think critically about important real-world questions through the eyes of an economist. All of these are new.

- *What If...* the government engages in policies that force down the price of an item subject to external benefits while leaving its supply curve's position unchanged?
- *What If...* joining a new regional trade bloc shifts existing trade to countries within that bloc and away from countries in another regional trade bloc?

WHAT IF...

joining a new regional trade bloc shifts existing trade to countries within that bloc and away from countries in another regional trade bloc?

If joining a new regional trade bloc shifts existing trade from the old bloc to the new one, then formation of the new trade bloc has generated trade diversion. The consequence is that formation of the new regional trade

bloc has failed to bring about an expansion of total world trade. Thus, the aggregate amount of international trade will remain unaffected by formation of the new bloc.

YOU ARE THERE FEATURES

demonstrate to students how real people in the real world react to changes in our economic environment and to policy changes. All of these are new.

- Addressing Rail-Freight Transportation Externalities
- Reducing the Opportunity Cost of Waiting in Gridlocked Traffic, at a Price

YOU ARE THERE

Addressing Rail-Freight Transportation Externalities

Noble Boykin, Jr., an attorney in Savannah, Georgia, is at his wit's end. Each day, about eight freight trains pass along a three-mile stretch through the city near his law firm's location. Locomotive operators blast their horns at each of the 24 rail crossings along the route. If Boykin and other attorneys at the firms are in the midst of recording depositions from clients or witnesses when trains pass, they must halt for time-consuming "train breaks." If a phone call with a court official is in progress as a train approaches, Boykin has a choice between apologetically postponing the call or quickly stepping into a closet. Boykin's home also is located near the same stretch of rails. Passing trains often delay his daily commutes, and he sometimes is awakened during the night by the soundings of the locomotives' horns.

The volume of items shipped by rail in the United States has risen more than 10 percent since 2010. Trains contain more cars, and the greater weights, pulled by locomotives also have slowed many trains along their routes. Consequently, trains typically require more time to traverse distances than in past years. In many locales, the results have been longer periods of noisy train operations and related traffic delays for people such as Boykin.

A growing number of U.S. communities are requiring rail firms to incur costs for the noise and delays they create. Some cities have instructed their police forces to issue tickets assessing fines of hundreds of dollars on rail firms each time their operations are judged to have created unjustifiable traffic delays. A few are even requiring firms to erect walls beside portions of their track to provide sound buffers. In these ways, rail companies are being required to take into account spillover effects of their activities in the market for freight transportation services.

CRITICAL THINKING QUESTIONS

1. How does a city's decision to assess substantial fines on rail operators that persistently generate traffic congestion affect the supply curve for rail services within the city?
2. Why do you think that the federal government requires rail operators to mount expensive horns and sound them—at prescribed decibel levels—at all street crossings? (*Hint:* What significant negative spillovers can a train create at a street crossing?)


Sources are listed at the end of this chapter.

MYECONLAB: PRACTICE, ENGAGE, AND ASSESS

MyEconLab is a powerful assessment and tutorial system that works hand-in-hand with *Economics Today*. **MyEconLab** includes comprehensive homework, quiz, test, and tutorial options, allowing instructors to manage all assessment needs in one program.

For the Instructor

- Instructors can select a prebuilt course option, which creates a ready-to-go course with homework and quizzes already set up. Instructors can also choose to create their own assignments and add them to the preloaded course. Or, instructors can start from a blank course.

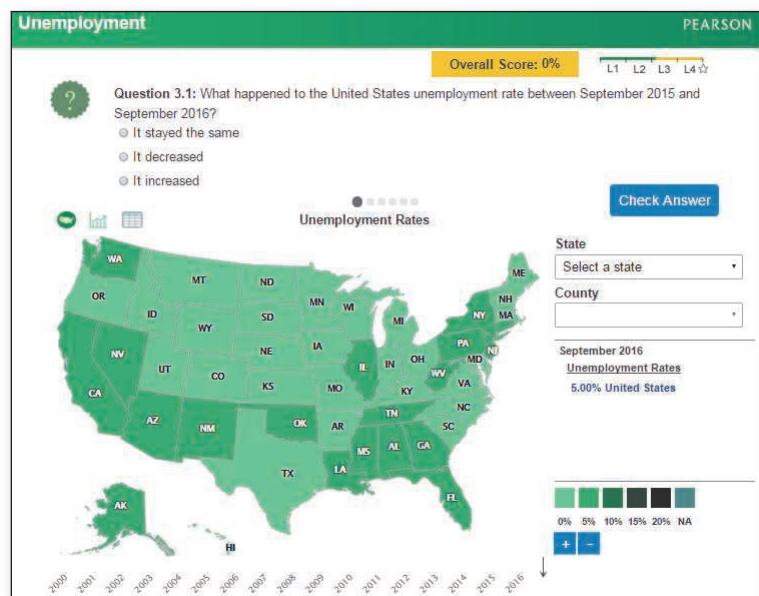
- All end-of-chapter problems are assignable and automatically graded in MyEconLab and, for most chapters, additional algorithmic, draw-graph, and numerical exercises are available to choose among.
- Instructors can also choose questions from the Test Bank and use the Custom Exercise Builder to create their own problems for assignment.
- The powerful Gradebook records each student's performance and time spent on the Tests and Study Plan, and generates reports by student or by chapter.
- **Math Review Exercises** in MyEconLab. MyEconLab now offers a rich array of assignable and auto-graded exercises covering fundamental math concepts geared for economics students. Aimed at increasing student confidence and success, the new math skills review Chapter R is accessible from the assignment manager and contains over 150 graphing, algebra, and calculus exercises for homework, quiz, and test use.
- **Real-Time Data Analysis Exercises** are marked with  and allow instructors to assign problems that use up-to-the-minute data. Each RTDA exercise loads the appropriate and most currently available data from FRED®, a comprehensive and up-to-date data set maintained by the Federal Reserve Bank of St. Louis. Exercises are graded based on that instance of data, and feedback is provided.
- In the eText available in MyEconLab, select figures labeled **Real-Time Data** now include a pop-up graph updated with real-time data from FRED®.
- **Current News Exercises** provide a turn-key way to assign gradable news-based exercises in MyEconLab. Every week, Pearson scours the news and finds micro- and macroeconomic news stories (articles and videos), creates an accompanying exercise, and then posts it all to MyEconLab courses for possible assignment. Assigning and grading current news-based exercises that deal with the latest micro and macro events and policy issues has never been more convenient.
- **Experiments in MyEconLab** are a fun and engaging way to promote active learning and mastery of important economic concepts. Pearson's experiments program is flexible and easy for instructors and students to use.
 - Single-player experiments allow your students to play an experiment against virtual players from anywhere at any time with an Internet connection.
 - Multiplayer experiments allow you to assign and manage a real-time experiment with your class.
 In both cases, pre- and post-questions for each experiment are available for assignment in MyEconLab.



Digital Interactives help to facilitate experiential learning through a set of interactives focused on core economic concepts. Fueled by data, decision-making, and personal relevance, each interactive progresses through a series of levels that build on foundational concepts, enabling a new immersive learning experience. The flexible and modular set-up of each interactive makes digital interactives suitable for classroom presentation, auto-graded homework, or both.

Learning Catalytics™ is a technology that has grown out of twenty years of cutting-edge research, innovation, and implementation of interactive teaching and peer instruction. Learning Catalytics is a “bring your own device” student engagement and classroom intelligence system. With Learning Catalytics you can:

- Engage students in real time, using open-ended tasks to probe student understanding.
 - Students use any modern Web-enabled device they already have — laptop, smartphone, or tablet.
 - Eighteen different question types include: word clouds; graphing; short answer; matching; multiple choice; highlighting; and image upload.
 - Address misconceptions before students leave the classroom.
 - Understand immediately where students are and adjust your lecture accordingly.



- Improve your students' critical-thinking skills.
- Engage with and record the participation of every student in your classroom.
- Learning Catalytics gives you the flexibility to create your own questions to fit your course exactly or choose from a library of Pearson-created questions.

For more information, visit learningcatalytics.com.

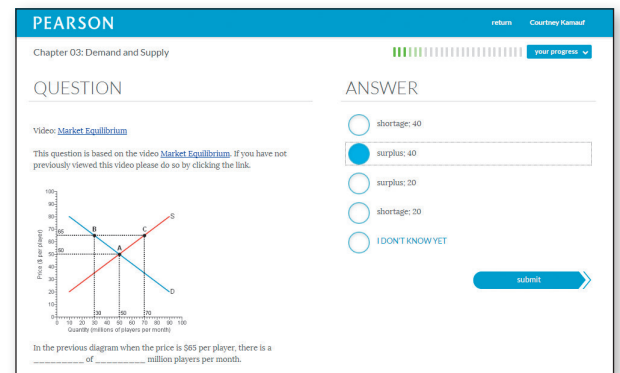
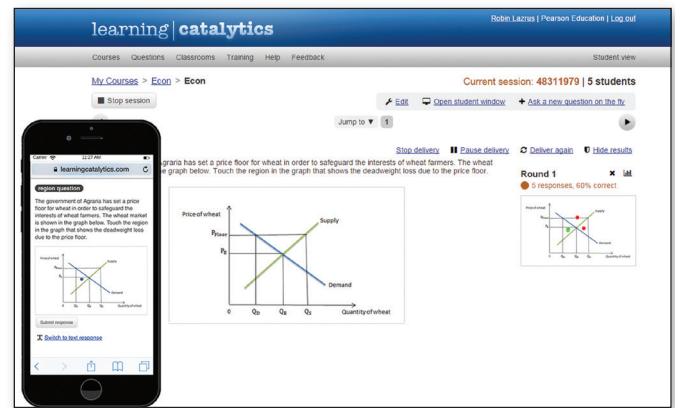
Dynamic Study Modules: Dynamic Study Modules continuously assess student performance on key topics in real time. Dynamic Study Modules exist for every chapter to provide additional practice for students around key concepts.

For the Student

Students are in control of their own learning through a collection of tests, practice, and study tools. Highlights include:

- Two Sample Tests per chapter are preloaded in MyEconLab, enabling students to practice what they have learned, to test their understanding, and to identify areas for further work.
- Based on each student's performance on homework, quizzes, and tests, MyEconLab generates a Study Plan that shows where the student needs further study.
- Learning Aids, such as step-by-step guided solutions, a graphing tool, content-specific links to the eText, animated graphs, and glossary flashcards, help students master the material.

To learn more, and for a complete list of digital interactives, visit www.myeconlab.com.



SUPPLEMENTAL RESOURCES

Student and instructor materials provide tools for success.

Test Bank (Parts 1, 2, and 3) offer more than 10,000 multiple-choice and short answer questions, all of which are available in computerized format in the TestGen software. The significant revision process by author Jim Lee of Texas A&M University–Corpus Christi and accuracy reviewer Conor Molloy of Suffolk County Community College ensure the accuracy of problems and solutions in these revised and updated Test Banks. The Test Bank author has connected the questions to the general knowledge and skill guidelines found in the Association to Advance Collegiate Schools of Business (AACSB) assurance of learning standards.

The Instructor's Manual, prepared by Jim Lee of Texas A&M University–Corpus Christi, includes lecture-ready examples; chapter overviews; objectives; outlines; points to emphasize; answers to all critical analysis questions; answers to all end-of-chapter problems; suggested answers to “You Are There” questions; and selected references.

PowerPoint lecture presentations for each chapter, revised by Jim Lee of Texas A&M University–Corpus Christi, include figures, key terms, and concepts from the text.

Clicker PowerPoint slides allow professors to instantly quiz students in class and receive immediate feedback through Clicker Response System technology.

The Instructor Resource Center puts supplements right at instructors' fingertips. Visit www.pearsonhighered.com/irc to register.

Economics Today, 19th edition, is available as an eBook and can be purchased at most eBook retailers.

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For this 19th Edition of *Economics Today*, I was fortunate to have production management undertaken by Kathy Smith for our production house, Cenveo® Publisher Services. Her thoroughness went beyond the call of duty and I do thank her for that. At Pearson, Michelle Zeng oversaw management of this project. I greatly appreciated her professionalism.

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The continuing improvements to *MyEconLab* were accomplished by Melissa Honig and Courtney Kamouf. It remains the industry leader in online learning and instruction.

Jim Lee continued to revise and improve the three test banks. As always, the *Instructor's Manual* was fully revised by Jim Lee. My faithful, long-standing, and amazingly accurate "super reviewer," is Professor Dan Benjamin of Clemson University. He knows how much I appreciate his great work. My assistant, Sue Jasin, was responsible for the many drafts of all of the updated and revisions, particularly the new Issues and Applications, other features, and examples. Thank you for "burning the midnight oil."

I do welcome ideas and criticisms from professors and students alike and hope that you enjoy the latest edition of *Economics Today*.

R.L.M.

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The Nature of Economics

1



oleksandr Sokolov/123RF.com

Just two decades ago, about a third of women with medical or doctoral degrees and aged 40 to 44 were childless, but today this fraction has fallen to a fifth. In addition, twenty years ago less than half of women holding a master's degree had two or more children, whereas now 60 percent are rearing multiple children. What accounts for the increased willingness of women with higher levels of education to bear children? In this chapter, you will learn that the answer lies in altered *incentives* to bear and raise children. Incentives, you will discover, play a crucial role in influencing all of the economic choices that people make, including decisions about whether to become parents.

LEARNING OBJECTIVES

After reading this chapter, you should be able to:

- 1.1** Define economics and discuss the difference between microeconomics and macroeconomics
- 1.2** Identify the three basic economic questions and the two opposing sets of answers
- 1.3** Evaluate the role that rational self-interest plays in economic analysis
- 1.4** Explain why economics is a science
- 1.5** Distinguish between positive and normative economics

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DID YOU KNOW THAT...

married people typically are healthier individuals? Careful study of the relationship between marriage and health indicates that for young people, better health raises the probability of getting hitched. Individuals who experience good health are more likely to meet, fall in love, and marry. Researchers have found that for people over the age of 39, however, married couples benefit from a “protective effect,” in which the state of being married generates better health than that experienced by unmarried people. As a consequence, the probability of a married person living to the next year is higher than an unmarried individual’s probability of surviving another year. This survival-probability differential rises as people age. The main reason for this protective effect is that marriage alters a couple’s behavior. A caring marital partner whose self-interested goal is to maintain a long-term relationship with another individual naturally desires to promote a lengthy lifespan for that person. Thus, the partner encourages that person to make more healthful choices regarding eating habits, monitors the individual’s health for signs of problems that might require care, and offers reminders for the individual to obtain regular physician checkups.

In this chapter, you will learn why contemplating the nature of self-interested responses to **incentives** is the starting point for analyzing choices people make in all walks of life. After all, how much time you devote to studying economics in this introductory course depends in part on the incentives established by your instructor’s grading system. As you will see, self-interest and incentives are the underpinnings for all the decisions you and others around you make each day.

Incentives

Rewards or penalties for engaging in a particular activity.

1.1 Define economics and discuss the difference between microeconomics and macroeconomics

The Power of Economic Analysis

Simply knowing that self-interest and incentives are central to any decision-making process is not sufficient for predicting the choices that people will actually make. You also have to develop a framework that will allow you to analyze solutions to each economic problem—whether you are trying to decide how much to study, which courses to take, whether to finish school, or whether the U.S. government should provide more grants to universities or raise taxes. The framework that you will learn in this text is the *economic way of thinking*.

This framework gives you power—the power to reach informed judgments about what is happening in the world. You can, of course, live your life without the power of economic analysis as part of your analytical framework. Indeed, most people do. Economists believe, though, that economic analysis can help you make better decisions concerning your career, your education, financing your home, and other important matters.

In the business world, the power of economic analysis can help increase your competitive edge as an employee or as the owner of a business. As a voter, for the rest of your life you will be asked to make judgments about policies that are advocated by political parties. Many of these policies will deal with questions related to international economics, such as whether the U.S. government should encourage or discourage immigration or restrict other countries from selling their goods here.

Defining Economics

Economics is part of the social sciences and, as such, seeks explanations of real events. All social sciences analyze human behavior, as opposed to the physical sciences, which generally analyze the behavior of electrons, atoms, and other nonhuman phenomena.

Economics is the study of how people allocate their limited resources in an attempt to satisfy their unlimited wants. As such, economics is the study of how people make choices.

To understand this definition fully, two other words need explaining: *resources* and *wants*. **Resources** are things that have value and, more specifically, are used to produce goods and services that satisfy people’s wants. **Wants** are all of the items that people would purchase if they had unlimited income.

Economics

The study of how people allocate their limited resources to satisfy their unlimited wants.

Resources

Things used to produce goods and services to satisfy people’s wants.

Wants

What people would buy if their incomes were unlimited.

Whenever an individual, a business, or a nation faces alternatives, a choice must be made, and economics helps us study how those choices are made. For example, you have to choose how to spend your limited income. You also have to choose how to spend your limited time. You may have to choose how many of your company's limited resources to allocate to advertising and how many to allocate to new-product research. In economics, we examine situations in which individuals choose how to do things, when to do things, and with whom to do them. Ultimately, the purpose of economics is to explain choices.

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Microeconomics versus Macroeconomics

Economics is typically divided into two types of analysis: **microeconomics** and **macroeconomics**.

Microeconomics is the part of economic analysis that studies decision making undertaken by individuals (or households) and by firms. It is like looking through a microscope to focus on the small parts of our economy.

Macroeconomics is the part of economic analysis that studies the behavior of the economy as a whole. It deals with economywide phenomena such as changes in unemployment, in the general price level, and in national income.

Microeconomic analysis, for example, is concerned with the effects of changes in the price of gasoline relative to that of other energy sources. It examines the effects of new taxes on a specific product or industry. If the government establishes new health care regulations, how individual firms and consumers would react to those regulations would be in the realm of microeconomics. The effects of higher wages brought about by an effective union strike would also be analyzed using the tools of microeconomics.

In contrast, issues such as the rate of inflation, the amount of economywide unemployment, and the yearly growth in the output of goods and services in the nation all fall into the realm of macroeconomic analysis. In other words, macroeconomics deals with **aggregates**, or totals—such as total output in an economy.

Be aware, however, of the blending of microeconomics and macroeconomics in modern economic theory. Modern economists are increasingly using microeconomic analysis—the study of decision making by individuals and by firms—as the basis of macroeconomic analysis. They do this because even though macroeconomic analysis focuses on aggregates, those aggregates are the result of choices made by individuals and firms.

What change in the world of work has *both* microeconomic *and* macroeconomic effects?

Microeconomics

The study of decision making undertaken by individuals (or households) and by firms.

Macroeconomics

The study of the behavior of the economy as a whole, including such economywide phenomena as changes in unemployment, the general price level, and national income.

Aggregates

Total amounts or quantities. Aggregate demand, for example, is total planned expenditures throughout a nation.

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EXAMPLE

Microeconomic and Macroeconomic Implications of the Gig Economy

In years past, most people seeking income-generating labor employment applied for positions with firms that offered on-going wages and benefits such as employer-provided pension or health care plans. Today, however, about one-third of the nearly 160 million people deemed to be “employed” participate in what many observers call the *gig economy*—a setting in which people receive fixed payments for performing specific short-term tasks, or “gigs.”

From a microeconomic perspective, the development of this gig economy has altered the decision-making process for many individuals and firms. Rather than receiving hourly wages and on-going

benefits, gig workers receive multiple contractual payments. Then these workers must choose how to allocate their income to any items they wish to buy, including pension or health care services. Instead of allocating funds for wage or salary payments, firms now devote resources to staffing short-term projects. Resources that previously had been devoted to managing full-time employees have been shifted to the coordination of tasks provided by a wide range of freelancers providing services under terms of short-horizon contracts.

From a macroeconomic viewpoint, expansion of the gig economy during the past decade has contributed to a rise in the part-time share

(continued)

of employment from less than 17 percent less than a decade ago to above 20 percent today. As a consequence, economists now debate whether the overall U.S. economy has really moved closer to being “fully employed” given that many of the new “jobs” that people recently have acquired are held by part-time freelance workers.

FOR CRITICAL THINKING

Why do you suppose that economists sometimes disagree about whether to classify freelancers who provide paid consulting services to businesses as “workers” or “firms”?

Sources are listed at the end of this chapter.

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1.2 Identify the three basic economic questions and the two opposing sets of answers

Economic system

A society's institutional mechanism for determining the way in which scarce resources are used to satisfy human desires.

The Three Basic Economic Questions and Two Opposing Sets of Answers

In every nation, three fundamental questions must be addressed irrespective of the form of its government or who heads that government, how rich or how poor the nation may be, or what type of **economic system**—the institutional mechanism through which resources are utilized to satisfy human wants—has been chosen.

The Three Basic Questions

The three fundamental questions of economics concern the problem of how to allocate society's scarce resources:

1. *What and how much will be produced?* Some mechanism must exist for determining which items will be produced while others remain inventors' pipe dreams or individuals' unfulfilled desires.
2. *How will items be produced?* There are many ways to produce a desired item. It is possible to use more labor and fewer machines, or vice versa. It is possible, for instance, to produce an item with an aim to maximize the number of people employed. Alternatively, an item may be produced with an aim to minimize the total expenses that members of society incur. Somehow, a decision must be made about the mix of resources used in production, the way in which they are organized, and how they are brought together at a particular location.
3. *For whom will items be produced?* Once an item is produced, who should be able to obtain it? People use scarce resources to produce any item, so typically people value access to that item. Thus, determining a mechanism for distributing produced items is a crucial issue for any society.

Now that you know the questions an economic system must answer, how do current systems actually answer them?

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Two Opposing Sets of Answers

At any point in time, every nation has its own economic system. How a nation's residents go about answering the three basic economic questions depends on that nation's economic system.

CENTRALIZED COMMAND AND CONTROL Throughout history, one common type of economic system has been *command and control* (also called *central planning*) by a centralized authority, such as a king or queen, a dictator, a central government, or some other type of authority. Such an entity assumes responsibility for addressing fundamental economic issues. Under command and control, this authority decides what items to produce and how many, determines how the scarce resources will be organized in the items' production, and identifies who will be able to obtain the items.

For instance, in a command-and-control economic system, a government might decide that particular types of automobiles ought to be produced in certain numbers. The government might issue specific rules for how to manage the production of these vehicles, or it might even establish ownership over those resources so that it can make all such resource allocation decisions directly. Finally, the government will then decide who will be authorized to purchase or otherwise utilize the vehicles.

THE PRICE SYSTEM The alternative to command and control is the *price system* (also called a *market system*), which is a shorthand term describing an economic system that answers the three basic economic questions via decentralized decision making. Under a pure price system, individuals and families own all of the scarce resources used in production. Consequently, choices about what and how many items to produce are left to private parties to determine on their own initiative, as are decisions about how to go about producing those items. Furthermore, individuals and families choose how to allocate their own incomes to obtain the produced items at prices established via privately organized mechanisms.

In the price system, which you will learn about in considerable detail in Chapters 3 and 4, prices define the terms under which people agree to make exchanges. Prices signal to everyone within a price system which resources are relatively scarce and which are relatively abundant. This *signaling* aspect of the price system provides information to individual buyers and sellers about what and how many items should be produced, how production of items should be organized, and who will choose to buy the produced items.

Thus, in a price system, individuals and families own the facilities used to produce automobiles. They decide which types of automobiles to produce, how many of them to produce, and how to bring labor and machines together within their facilities to generate the desired production. Other individuals and families decide how much of their earnings they wish to spend on automobiles.

WHAT IF...

the government increases pharmaceutical companies' costs but prevents them from raising their prices?

In fact, in recent years the U.S. government's Food and Drug Administration (FDA) has required many pharmaceutical firms to use higher-cost production techniques to produce drugs. At the same time, the government has prevented the companies from adjusting their prices to take fully into

account the higher expenses required to utilize the prescribed techniques and equipment. The failure of pharmaceutical prices to fully reflect the rising costs of producing the drugs has provided a signal to the owners of some manufacturers that they should reduce or even halt production.

MIXED ECONOMIC SYSTEMS By and large, the economic systems of the world's nations are mixed economic systems that incorporate aspects of both centralized command and control and a decentralized price system. At any given time, some nations lean toward centralized mechanisms of command and control and allow relatively little scope for decentralized decision making. At the same time, other nations limit the extent to which a central authority dictates answers to the three basic economic questions, leaving people mostly free to utilize a decentralized price system to generate their own answers.

A given country may reach different decisions at different times about how much to rely on command and control versus a price system to answer its three basic economic questions. Until 2008, for instance, U.S. residents preferred to rely mainly on a decentralized price system to decide which and how many financial services to produce and how to produce them. Since then, the U.S. government has owned substantial fractions of financial firms and hence has exerted considerable command-and-control authority over production of financial services.

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1.3 Evaluate the role that rational self-interest plays in economic analysis

Rationality assumption

The assumption that people do not intentionally make decisions that would leave them worse off.

YOU ARE THERE

To consider why chicken farmers have an incentive to try to understand the clucks of chickens, take a look at **The Incentive to Understand Chickens' "Speech"** on page 11.

The Economic Approach: Systematic Decisions

Economists assume that individuals act *as if* they systematically pursue self-motivated interests and respond predictably to perceived opportunities to attain those interests. This central insight of economics was first clearly articulated by Adam Smith in 1776. Smith wrote in his most famous book, *An Inquiry into the Nature and Causes of the Wealth of Nations*, that “it is not from the benevolence [good will] of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.” Thus, the typical person about whom economists make behavioral predictions is assumed to act *as though* he or she systematically pursues self-motivated interest.

The Rationality Assumption

The **rationality assumption** of economics, simply stated, is as follows:

We assume that individuals do not intentionally make decisions that would leave them worse off.

The distinction here is between what people may think—the realm of psychology and psychiatry and perhaps sociology—and what they do. Economics does *not* involve itself in analyzing individual or group thought processes. Economics looks at what people actually do in life with their limited resources. It does little good to criticize the rationality assumption by stating, “Nobody thinks that way” or “I never think that way” or “How unrealistic! That’s as irrational as anyone can get!” In a world in which people can be atypical in countless ways, economists find it useful to concentrate on discovering the baseline. Knowing what happens on average is a good place to start. In this way, we avoid building our thinking on exceptions rather than on reality.

Take the example of driving. When you consider passing another car on a two-lane highway with oncoming traffic, you have to make very quick decisions: You must estimate the speed of the car that you are going to pass, the speed of the oncoming cars, the distance between your car and the oncoming cars, and your car’s potential rate of acceleration. If we were to apply a model to your behavior, we would use the rules of calculus. In actual fact, you and most other drivers in such a situation do not actually think of using the rules of calculus, but to predict your behavior, we could make the prediction *as if* you understood those rules.

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Responding to Incentives

If it can be assumed that individuals never intentionally make decisions that would leave them worse off, then almost by definition they will respond to changes in incentives. Indeed, much of human behavior can be explained in terms of how individuals respond to changing incentives over time.

Schoolchildren are motivated to do better by a variety of incentive systems, ranging from gold stars and certificates of achievement when they are young, to better grades with accompanying promises of a “better life” as they get older. Of course, negative incentives affect our behavior, too. Penalties, punishments, and other forms of negative incentives can raise the total cost of engaging in various activities.

How did incentive effects of *higher* tax rates in Greece contribute to a *reduction* in tax receipts by the nation’s government?

INTERNATIONAL POLICY EXAMPLE

Greece Discovers That Higher Tax Rates Encourage More Tax Evasion

During the past few years, the government of Greece has implemented gradual increases in several tax rates. The government has raised by several percentage points the top basic income tax rate applied to households.

This tax rate is now 42 percent, which is among the highest income tax rates in Europe. In addition, it has imposed an additional 4 percent “solidarity tax rate” on household incomes that initially was to last a single year

but has been extended for several more years. Furthermore, it has increased the corporate income tax rate from 20 percent to 33 percent.

The Greek government intended for the higher tax rates to generate billions of dollars in new tax revenues. In fact, however, the government's tax revenues have *declined* slightly. A key reason for this revenue drop-off has been that residents of Greece responded to the higher tax rates by boosting their efforts to evade paying taxes. Since 2010, when the Greek government began phasing in higher tax rates, the share of taxes actually collected as a percentage of taxes legally owed has declined from about 60 percent—which already was Europe's lowest—to less than 50 percent. Thus, raising tax rates has

given Greek residents a greater incentive to evade taxes, which has contributed to the decrease in government tax revenues that followed the tax-rate boosts.

FOR CRITICAL THINKING

How do you suppose that higher tax rates have affected the incentive for Greek residents to engage in tax avoidance, or legally reducing tax liabilities, including earning less income that is subjected to taxation?

Sources are listed at the end of this chapter.

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Defining Self-Interest

Self-interest does not always mean increasing one's wealth measured in dollars and cents. We assume that individuals seek many goals, not just increased wealth measured in monetary terms. Thus, the self-interest part of our economic-person assumption includes goals relating to prestige, friendship, love, power, helping others, creating works of art, and many other matters. We can also think in terms of enlightened self-interest, whereby individuals, in the pursuit of what makes them better off, also achieve the betterment of others around them. In brief, individuals are assumed to want the ability to further their goals by making decisions about how items around them are used. The head of a charitable organization usually will not turn down an additional contribution, because accepting the funds yields control over how they are used, even though their use is for other people's benefit.

Why do many women continue to pursue their self-interest by holding traditionally "female" jobs that offer lower pay than work more commonly performed by men?

SELF CHECK

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BEHAVIORAL EXAMPLE

Why Doesn't Higher Pay Persuade Some Women to Avoid Traditional Gender Roles?

In 1980, U.S. women earned 35 percent less, on average, than men. This "gender gap" in earnings has declined in the years since, to just above 20 percent today. The gap remains primarily because many young women continue to choose traditionally female occupations, such as jobs as receptionists, secretaries, and housekeepers. These women allocate their time to such work even though they have more years of education than the average male and hence often would qualify for higher-paying work in other positions.

Behavioral economists have found an element that helps to explain this observation: the large number of women who recently immigrated to the United States from countries using languages with unambiguously feminine names for certain jobs. For instance, the Spanish word for people who engage in cleaning tasks is concretely feminine and translates into English

as "maids." Behavioral economists have found that such languages appear to be closely associated with cultural traditions in which many immigrant women opt for work in predominantly "female" occupations. For these women, higher pay for jobs mainly held by men apparently is an insufficient incentive to induce them to reverse traditional behaviors that reinforce stereotypical gender roles—and that generate lower pay.

FOR CRITICAL THINKING

Why do you suppose that second- and third-generation females of U.S. immigrant families are found to be more likely to accept working alongside males in higher-paying jobs?

Sources are listed at the end of this chapter.

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Economics as a Science

Economics is a social science that employs the same kinds of methods used in other sciences, such as biology, physics, and chemistry. Like these other sciences, economics uses models, or theories. Economic **models, or theories**, are simplified representations of the real world that we use to help us understand, explain, and predict

1.4 Explain why economics is a science

Models, or theories

Simplified representations of the real world used as the basis for predictions or explanations.

economic phenomena in the real world. There are, of course, differences between sciences. The social sciences—especially economics—make little use of laboratory experiments in which changes in variables are studied under controlled conditions. Rather, social scientists, and especially economists, usually have to test their models, or theories, by examining what has already happened in the real world.

Models and Realism

At the outset it must be emphasized that no model in *any* science, and therefore no economic model, is complete in the sense that it captures *every* detail or interrelationship that exists. Indeed, a model, by definition, is an abstraction from reality. It is conceptually impossible to construct a perfectly complete realistic model. For example, in physics we cannot account for every molecule and its position and certainly not for every atom and subatomic particle. Not only is such a model unreasonably expensive to build, but working with it would be impossibly complex.

The nature of scientific model building is that the model should capture only the *essential* relationships that are sufficient to analyze the particular problem or answer the particular question with which we are concerned. *An economic model cannot be faulted as unrealistic simply because it does not represent every detail of the real world.* A map of a city that shows only major streets is not faulty if, in fact, all you wish to know is how to pass through the city using major streets. As long as a model is able to shed light on the *central* issue at hand or forces at work, it may be useful.

A map is the quintessential model. It is *always* a simplified representation. It is *always* unrealistic. It is, however, also useful in making predictions about the world. If the model—the map—predicts that when you take Campus Avenue to the north, you always run into the campus, that is a prediction. If a simple model can explain observed behavior in repeated settings just as well as a complex model, the simple model has some value and is probably easier to use.

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Assumptions

Every model, or theory, must be based on a set of assumptions. Assumptions define the array of circumstances in which our model is most likely to be applicable. When some people predicted that sailing ships would fall off the edge of the earth, they used the *assumption* that the earth was flat. Columbus did not accept the implications of such a model because he did not accept its assumptions. He assumed that the world was round. The real-world test of his own model refuted the flat-earth model. Indirectly, then, it was a test of the assumption of the flat-earth model.

Is it possible to use our knowledge about assumptions to understand why driving directions sometimes contain very few details?

EXAMPLE

Getting Directions

Assumptions are a shorthand for reality. Imagine that you have decided to drive from your home in San Diego to downtown San Francisco. Because you have never driven this route, you decide to use a travel-planner device such as global-positioning-system equipment.

When you ask for directions, the electronic travel planner could give you a set of detailed maps that shows each city through which you will travel—Oceanside, San Clemente, Irvine, Anaheim, Los Angeles, Bakersfield, Modesto, and so on—with the individual maps showing you exactly how the freeway threads through each of these cities. You would get a nearly complete description of reality because the GPS travel planner will not have used many simplifying assumptions. It is more likely, however, that the

travel planner will simply say, “Get on Interstate 5 going north. Stay on it for about 500 miles. Follow the signs for San Francisco. After crossing the toll bridge, take any exit marked ‘Downtown.’” By omitting all of the trivial details, the travel planner has told you all that you really need and want to know. The models you will be using in this text are similar to the simplified directions on how to drive from San Diego to San Francisco—they focus on what is relevant to the problem at hand and omit what is not.

FOR CRITICAL THINKING

In what way do small talk and gossip represent the use of simplifying assumptions?

THE CETERIS PARIBUS ASSUMPTION: ALL OTHER THINGS BEING EQUAL Everything in the world seems to relate in some way to everything else in the world. It would be impossible to isolate the effects of changes in one variable on another variable if we always had to worry about the many other variables that might also enter the analysis. Similar to other sciences, economics uses the *ceteris paribus* assumption. *Ceteris paribus* means “other things constant” or “other things equal.”

Consider an example taken from economics. One of the most important determinants of how much of a particular product a family buys is how expensive that product is relative to other products. We know that in addition to relative prices, other factors influence decisions about making purchases. Some of them have to do with income, others with tastes, and yet others with custom and religious beliefs. Whatever these other factors are, we hold them constant when we look at the relationship between changes in prices and changes in how much of a given product people will purchase.

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Ceteris paribus [KAY-ter-us PEAR-uh-bus] assumption

The assumption that nothing changes except the factor or factors being studied.

Deciding on the Usefulness of a Model

We generally do not attempt to determine the usefulness, or “goodness,” of a model merely by evaluating how realistic its assumptions are. Rather, we consider a model “good” if it yields usable predictions that are supported by real-world observations. In other words, can we use the model to predict what will happen in the world around us? Does the model provide useful implications about how things happen in our world?

Once we have determined that the model may be useful in predicting real-world phenomena, the scientific approach to the analysis of the world around us requires that we consider evidence. Evidence is used to test the usefulness of a model. This is why we call economics an **empirical** science. *Empirical* means that evidence (data) is looked at to see whether we are right. Economists are often engaged in empirically testing their models.

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Empirical

Relying on real-world data in evaluating the usefulness of a model.

Models of Behavior, Not Thought Processes

Take special note of the fact that economists’ models do not relate to the way people *think*. Economic models relate to the way people *act*, to what they do in life with their limited resources. Normally, the economist does not attempt to predict how people will think about a particular topic, such as a higher price of oil products, accelerated inflation, or higher taxes. Rather, the task at hand is to predict how people will behave, which may be quite different from what they *say* they will do (much to the consternation of poll takers and market researchers). Thus, people’s *declared* preferences are generally of little use in testing economic theories, which aim to explain and predict people’s *revealed* preferences. The people involved in examining thought processes are psychologists and psychiatrists, not typically economists. MyEconLab Concept Check

Behavioral Economics and Bounded Rationality

In recent years, some economists have proposed paying more attention to psychologists and psychiatrists. They have suggested an alternative approach to economic analysis. Their approach, known as **behavioral economics**, examines consumer behavior in the face of psychological limitations and complications that may interfere with rational decision making.

Behavioral economics

An approach to the study of consumer behavior that emphasizes psychological limitations and complications that potentially interfere with rational decision making.

BOUNDED RATIONALITY Proponents of behavioral economics suggest that traditional economic models assume that people exhibit three “unrealistic” characteristics:

1. *Unbounded selfishness.* People are interested only in their own satisfaction.
2. *Unbounded willpower.* Their choices are always consistent with their long-term goals.
3. *Unbounded rationality.* They are able to consider every relevant choice.